RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

Since 1958

Post Office Box 1759, La Jolla, California 92038 | 17 Letters Per Year • $250 annually | www.dowtheoryletters.com

May 24, 2000 LETTER 1301

May 5, DJIA 10554.28; PTI 5132; A-D Ratio -7.03
May 12, DJIA 10603.31; PTI 5130; A-D Ratio -7.20
May 19, DJIA 10626.85; PTI 5124 ; A-D Ratio - 7.55
Dow Yield: 1.54%; Dow Price/Earnings: 21.1
Dow Times Book Value: 6.28% ; PTI 89-day exp. MA: 5157
Percentage of Undervalued Blue-chips: 16%
Gold 34-day MA: 278

THE PICTURE: The following is probably the most important concept to keep in mind during a bear market. "IN A PRIMARY BEAR MARKET VALUES DETERIORATE THROUGH TIME."

I've been thinking about why I've been so fascinated with the markets over the last 50 years. I think it's the drama, the sheer human and economic drama, which the stock market represents.

Consider the following which was written by Charles Dow almost a century ago, around the year 1902. *"There is always a disposition in people's minds to think that existing conditions will be permanent. When the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this one which is unlike its predecessors and give assurance of permanency. The one fact pertaining to all conditions is that they will change."*

These may be the wisest words ever written about the stock market. And nothing that has happened over the last hundred years has indicated that Dow's observations about markets and human psychology are wrong.

Although this is surely the most fundamental observation ever put forth about the stock market, the fascinating fact is that it is almost always ignored. It is ignored at the bottom of bear markets, and it is ignored at the top of bull markets. Maybe ignored is the wrong word, Dow's thesis isn't just ignored -- it's refuted.

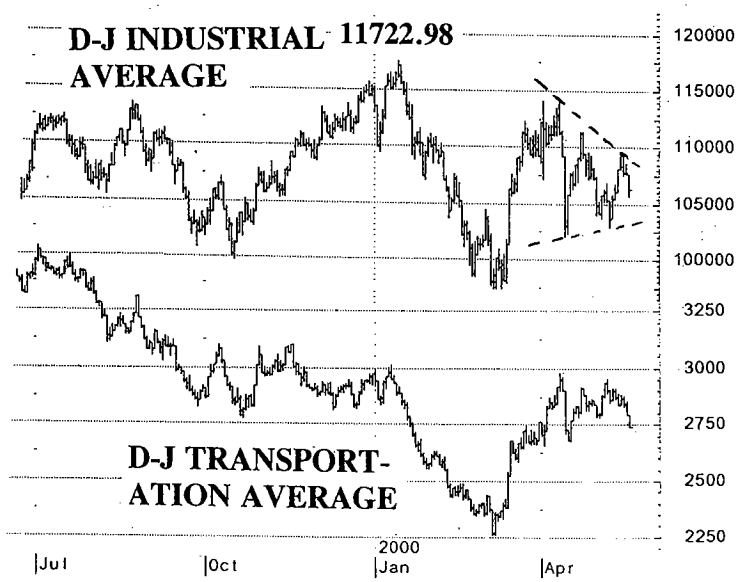
And I think to myself, "Isn't it amazing. All history tells us that something, some set of circumstances, some series of changes will occur that will serve, ultimately, to take this market down into the depths." It seems inconceivable as I write this, but somewhere ahead, be it a year or five years or even more, we are going to see the market sink to incredible lows. And as optimistic as people are today, that optimism is fated to turn to abject pessimism at or near the bear market's final termination.

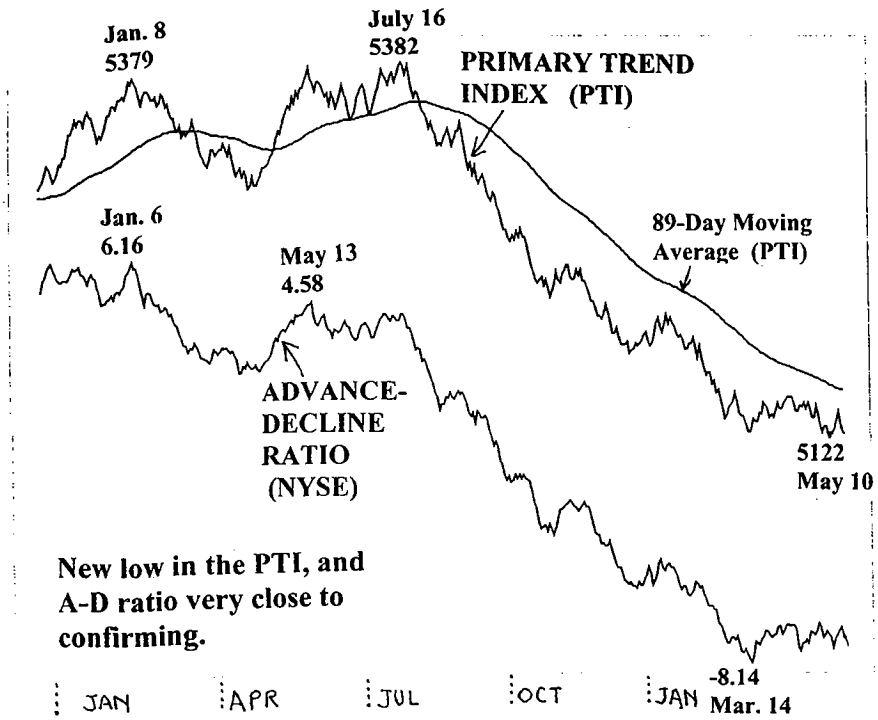
How can this possibly be? Here we have amazing new technologies never dreamed of in Dow's time. We have mutual funds, tens of millions of investors, TV and Internet programs which flash us prices instantaneously. We have newspapers with expanded business sections and we have talking heads gabbing around the clock on TV. Never has the stock market enjoyed a larger cheering section, and never have we seen anything approaching the current massive public participation and obsession in the stock market.

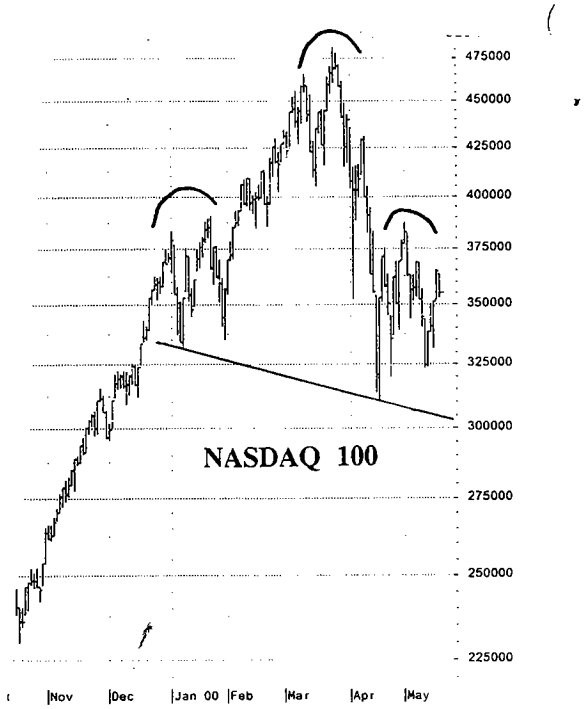
In the descriptions above, all I'm doing is describing the froth and optimism which is a part and parcel of today's environment. Today's national obsession is watching the stock market. Restaurants have TV sets tuned to the stock market, newspaper headlines describe the movements of the stock market, people on park benches argue about the stock market, teachers in elementary schools educate their pupils about the stock market and ladies at tea parties discuss the stock market.

STOCK TALK

Have your heard...? The market becomes conversation fodder for mainstream America







The drama, to my mind, the great drama, is exactly what Dow described -- the **drama of change.** And I keep wondering, what set of circumstances will change all this? If I had to hazard a guess, that guess would be deflation. Deflation possibly brought on, or at least augmented by, the Internet. When my wife decides to buy a flat screen for her PC, she doesn't run out to the store as she might have a few years ago. No, she looks up flat screens on the Internet and checks the best price and the best value. When Ford or GM need a part for a car, they buy that part through their new procurement agency which is a consortium of auto companies, and the bids go out.

The Internet will ultimately eliminate the middle man, the salesman and the broker. What an item costs is becoming general knowledge, and as a result profits will be squeezed. And all this is occurring in an era of great prosperity. What happens when business starts sliding and the public finally decides to save?

I think it was Yale Hirsch who calculated that if an investor had invested $10,000 in the stock market during the May to October period over the last 35 years, he would now have only $9,808. In other words, the real money has been made during the November to April period. This is the cyclical approach, and it is interesting that we are now in the negative segment of the cycle.

I want to expand a bit on the thesis that I started this Letter with, which is -- that during a bear market values deteriorate through time.

I consider that this primary bear market began on May 12, 1999: that was the last time the two Averages, Transports and Industrials, recorded bull market highs together.

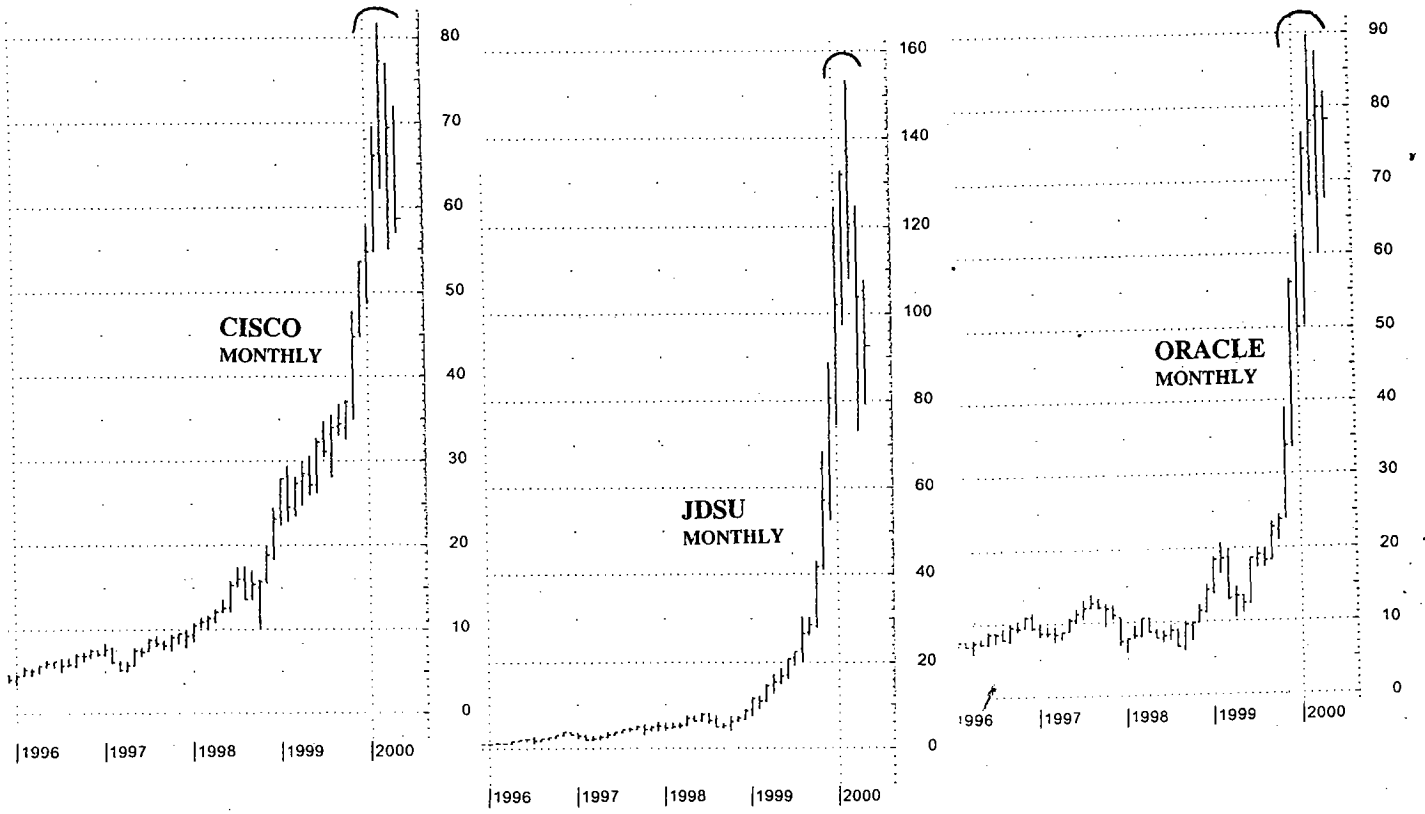
In the meantime, we received a bear market signal (Sept. 23, 1999) under Dow Theory -- and a re-confirmation of the bear market (Feb. 25, 2000).

A year has passed since the bear market began. A year has passed and the Dow and the Transports are still holding well above their March lows. For this reason, the bear may have a good deal of catching up to do on the downside.

My feeling is that the market will turn nasty somewhere ahead as the Averages and many stocks make up for lost time. We've been living through a period of extraordinary arrogance on the part of most so-called "experts" and analysts.

Recently the pressure is on the most flagrantly overvalued sector of the market, the Nasdaq and more specifically, the Nasdaq 100. I include on page 2 a chart of the Nasdaq 100, and the "head-and-shoulders top" pattern is clearly visible. A break below the critical support at roughly 3250 would send the Nasdaq 100 (and the Nasdaq) substantially lower.

Along these lines, I'm including **monthly** charts of some of a few leading tech growth stocks. Note the parabolic rises, and the more recent breakdowns from these parabolic rises. Once a parabola breaks down, as a rule you can kiss the highs good-bye for many months if not for years. A parabola expresses an extreme of optimism; and when that extreme dies out, the aftermath, more than likely, is a long path down as disillusionment sets in.



INVESTMENT POSITION: The bear remains in the box. He's waking up after his long sleep. The fact is, the bear is not even fully out of his lair yet. Wait -- now it looks as though he's stretching and even growling. Makes sense to stay away from him.

As far as investing, I prefer at this stage of the game that my subscribers buy only short-dated T-bills or short-dated AA-rated or better muni bonds. For those buying muni bonds, you can often get better rates by buying small pieces such as $10,000, $20,000 or even $5,000 lots. These are all odd-lots, and institutions in general won't bother with them, so they will often sell at bargain yields compared with even or full lots.

NOTES & QUOTES: Sports are losing their allure for viewers. Last month's NCAA men's finals drew the lowest ratings ever for CBS. Ratings for NBA basketball games are down 21% from last year. ABC's Monday Night Football hit bottom last season. Rights fees for sporting events have hit all-time highs while ratings are hitting all-time lows, and this is worrying the devil out of TV programmers. The question facing programmers: Are the dismal sports ratings just a projection of lower ratings in general for TV shows or are sports fans growing just plain tired of watching big-time sports?

One theory is that people are spending more time with their PCs and cutting down on TV time. My own theory is that there are too many sporting events, and that sports have become just a business. One year your favorite football team goes to the Super Bowl and the next year a third of your favorite team is gone -- to other teams. I know this -- I watch a lot less sports than I did five years ago, and I have let season tickets to the stadium lapse. I'm bored with the whole sports picture except for the NCAA basketball finals and the football playoffs.

* *

The parting gifts to CEO's of some corporations is a disgrace. Jill Barad of Mattel said good bye with a gift of $37 million. She got a further gift of around $700 thousand (annually) for life. Then there Conseco's Steve Hilbert, who said bye bye with a present of around $72 million. It's ridiculous. But that's what's happening in the fairyland atmosphere of the year 2000. When they asked the Chinese wise man for an expression that would fit every contingency in life, the wise man offered the following, "This too shall pass." Let's hope is applies to the corporate presents for departing CEOs.

* *

Colleges: My alma mater, NYU, just sent me their latest bulletin. It's interesting and indicative of what's happening in leading universities. NYU received 30,900 applications for the fall undergraduate admissions, highest in NYU's long history and the most for any private university in the US. The freshman class will be 3,500 students. Of the 2700 candidates who applied for early admission, 1100 have already been accepted, leaving only 2400 open places for

the over 30000 students who applied. Man, have things changed since I attended NYU under the GI bill in the '40s.

* *

Gone: A preliminary report by the Washington-based World Resources Institute found that half of the earth's forests and half of the earth's wetlands have been lost over the last 100 years. The report was the result of the work of over 200 scientists.

* *

With Mayor Giuliani suffering from prostrate cancer, Repubicans have come up with a new standard-bearer, good-looking Suffolk County Republican, Rick Lazio. States, Lazio "I'm the real thing. I don't have to try to be someones else. I was born here, I went to school here. I fished in these waters. I graduated from our schools. My children were born in New York. I've lived here my whole life. There will be no question of my commitment to this state." This guy is tough, and he's going for Hillary's Achilles Heel. Snaps Lazio, "Name one things that she's ever done for New York." Hey, rough battle ahead.

* *

The price of seats on the NYSE often go with the trend of the market. A few weeks ago three seats were sold, one for $1.65 million ($30,000 less than the previous sale on April 3) and two for $1.7 million. The record price for a seat was set last August 23 at $2.65 million. The Big Board said that in the fourth quarter it suffered its first loss in almost a decade.

* *

The trend of dividend increases has been slowing since 1997. Instead of raising dividends, companies have been buying back their own stock. For the S&P 500, fourth quarter 1998 S&P dividends were $4.00; first quarter 1999 dividends were $4.01; second quarter $4.18; third quarter $4.45; fourth quarter $4.05; first quarter year 2000 $4.08. Many companies feel that they can do better with their money than pay it out in dividends to stockholders. I disagree. One of the strongest forces under a stock is a long history of increasing dividends. Earnings are what an accountant says they are, but dividends are hard cash that a company must generate and keep generating if dividends are to be raised.

* *

I've been re-reading some of Warren Buffett's comments from Berkshire's last stockholders' meeting. He called the Internet IPO phenomenon a "Ponzi" scheme in that these new companies were brought out and sold to "greater fools" who hope to sell them to other "greater fools." More interesting, he felt that the Internet represented a giant "transfer of wealth" in which billions of dollars were collected by IPOs and that the net result would be intensified competition throughout the economy. In other words, Buffett was not impressed with the potential profits that might be generated by the nets. In fact, he thought that the net would be an instrument for squeezing profits.

My own experience is that the Internet is a great source of information, but it also shows me what to buy, who sells it, and who sells it at the best price. As far as profits, I believe the Internet is going to be a profit-squeezer, and that it is going to cost thousands of jobs for middle-men and salesmen. For a small amount of money, I can set up a site and offer to sell an item at a very small mark-up. Furthermore, I don't have to advertise, I don't need salesmen, and I don't need a huge back-up staff. The great thing about the Internet is that it is so easy to set up a site. The ominous thing about the Internet is that it is so easy to set up a site.

The other observation I will make is that when I first got on the Internet I would spend hours surfing, checking out site after site. Now I use maybe ten different sites, and that's about it. And I would guess that the average person does the same thing. So how in the world are these thousands of sites going to survive. The answer is that they won't. Only the best and the smartest and the most useful will survive. To my mind, that will eliminate up to 90% of all the sites now on the net.

* *

This from a subscriber: "Our Congress 'persons' don't pay into Social Security and, of course, they don't collect from it. The reason is -- they have a 'special retirement plan' that they voted for themselves years ago. For all practical purposes, it works like this. When they retire (or leave office) they continue to draw the same pay until they die, and it is increased from time to time for their cost-of-living adjustments. For instance, former Senator Bill Bradley and his wife are expected to draw $7.9 million. Mrs. Bradley would draw another $275,000 during the last year of her life. This is calculated on an average life span for each. This would be fine except -- they paid nothing toward any kind of retirement plan, nor do any Congress 'persons.' Their fine retirement package comes straight out of our general fund. It is OUR money."

This subscriber suggests that we "jerk the Golden Fleece retirement package from our Congress 'persons,' and make them qualify under the current Social Security system with the rest of us -- then watch how fast they fix it!!." **Russell asks:** Any subscriber want to comment on this? I've always said that regarding any bill before Congress: First figure how the bill will affect the bunch in Congress -- that will give you an idea of the bill's chances of passage.

* *

The historic merger of the London and Frankfurt stock exchanges announced three weeks ago appears to be the first step in the coalition of European financial markets. The new exchange will be known as the International Exchange ("IX") and will be located in London and promises to make Europe a potent competitor for the NYSE.

* *

San Diego has become the new digital coast and possibly the center of wireless technology. New offices are being built here so rapidly that local maps are out-of-date practically on a monthly basis. The San Diego area is now a center for biotech, software and telecommunications. But the key industry that's attracting international attention is wireless communications. The center of the wireless sector is Qualcomm with its sales of nearly $4 billion (QCOM actually makes a profit of nearly $700 million). Almost all the other wireless heavies have established a presence in San Diego including Ericsson, Nokia, Motorola and Kyocera. Giant privately-owned Science Applications is also headquartered here. San Diego is also home to about 800 other technology companies. What's the attraction of San Diego? The climate, the availability of land, it's proximity to LA, and the huge research facilities of UCSD; the University possesses one of the governments' two supercomputing centers, which attract high-end technical talent.

* *

Despite the collapse of many e-tailers, venture capital is still very much alive. Nationally, venture capitalists poured $22.7 billion into new companies during the first quarter of this year compared with $6.2 billion during the first quarter of 1999. In San Diego alone, venture capitalists put $510 million into 43 young companies during the first quarter of this year. This is an increase of 250% over last year.

* *

Donna Karan knows the advantage of taking a piece out of a company's gross rather than sharing in its profits. Since June 1996 when the company went public the stock has dropped 75%. Yet from 1996 through 1999 Donna Karan and her husband have taken $81 million in payments. The bulk of it or $76 million was taken out through royalty payments on sales of the Donna Karan trademark. In 1999 Donna Karan took a salary of $438,000 plus a bonus of $327,000. I understand that Tommy Hilfiger also takes a percentage of the gross. TOM sold for 41 last August. Today, TOM sold for just over 7.

* *

Many companies that have given options to their employees have seen their stocks collapse and the options then become worthless. This has been a problem for Microsoft. So MSFT has simply given its employees new options. As far as re-pricing options, a ruling expected by the Financial Accounting Standards Board may put a brake on the practice of re-pricing options. The new ruling would subject a company to potentially huge charges to earnings if it re-prices its options.

* *

When AT&T sold 6% of its wireless phone business, it also helped itself. In 1999, its wireless division lost $461 million compared with a profit of $108 million in '98. And there's no guarantee of when the losses will end. So what AT&T did was to transfer its wireless losses to another set of books. And the public is holding the losses. Which accounts for the lousy performance of AWE.

* *

A recent article in the *Economist* entitled "A Thinker's Guide" takes the position that buyers of net stocks are doomed. "In all technological revolutions from the railways to the Internet, the only sure long-term winners are consumers who gain from lower prices and hence higher real wages." Question: So why do people pay huge prices for Internet stocks? Answer: They don't know history.

* *

Faye and I used to wake up every morning with sore backs. Then we decided to do something about it. My daughter, Betsy, has been raving about her new Swedish mattress called the Tempur-pedic. So we went to a store in La Jolla called the HealthyBack. We tried out this new, high-tech composition mattress along with the Tempur-pedic pillow and presto -- we were sold. It's a composition mattress which is very firm, but it immediately moulds itself into your body's form. As soon as you move, the mattress flattens out at the old position and moulds to your new position. It's sort of like sleeping on firm Silly Putty. At any rate, if you have back trouble or have trouble sleeping, my recommendation is to try the Swedish Tempur-pedic mattress. I really believe that this type of mattress is going to revolutionize the mattress business. The problem -- the mattress is expensive, it cost over $1500.

* *

Analysts are now "shouting" their so-called "whisper numbers," meaning that the whispers are becoming rather loud. As an example, Stuart Linde of Lehman Bros. alerted his clients to a "trading opportunity" in casino operator Mandalay Resort Group. Why? Because the company could do better than his 38-cent forecast, better by 20% when it reports earnings on May 18. But Linde kept his estimate unchanged. So why didn't he change his estimate? Well, because when the earnings come out, they'll be better than his original estimate. Give me a break -- when does this nonsense stop.

* *

Before I forget, we now have a new high of 4,500 subscribers on the Internet and tuning into my daily site. I'd love to get the rest of my subscribers on the net, and it should be a lot easier with all the new non-PC ads hitting the newspapers and magazines. So if you are a subscriber, but you're not yet on the net, do yourself a favor, get the widely-advertised I-opener and leap into the twenty-first century. I-opener, by the way, is being sold at below cost -- at $200. Of course, there's a charge of $22 a month for access to the net, but with free e-mail, it's worth it; in fact, it's a bargain.

* *

Despite the well-publicized troubles of George Soros, Julian Robertson and Long Term Capital Management, investors are flocking to hedge funds, and the industry is growing rapidly in New York. In Manhattan alone, there are now 712 hedge funds, up 14% from just a year ago.

* *

How do you know when stocks are bargains? You might turn to the criteria put forth by famed stock-market guru, Ben Graham. Here they are:

(1) The company should owe less than its worth, and

(2) The earnings yield should be twice the prevailing AAA-rated bond yield, or

(3) The dividend yield should be less than two-thirds of the AAA-bond yield.

Wonder how many stocks would fit those criteria today?

* *

Subscribers know that I'm no fan of the Federal Reserve system, which is and always has been an "engine of inflation." But get this: according to a 1996 audit by the General Accounting Office, the Fed has an annual budget of $2 billion, it has 25,000 well-paid employees, it operates its own air force of 47 Lear jets and small cargo planes, it operates a large fleet of cars including personal cars for 59 Fed bank managers, it has a full-time curator who oversees the Fed's collection of expensive paintings and sculptures. According to the GAO, the number of Fed employees making more than $125,000 a year doubled (from 35 to 72) from 1993 to 1996. You wonder what the Fed would look like now, in the year 2000. All this to generate a collapse in the purchasing power of the dollar over the years. It's a damn disgrace, but what politician would dare question, much less attack the Fed? The Fed has become the most powerful agency in Washington. Who controls the money, controls the nation. Historically, the Fed has done pretty much what the party in power wants it to do. Nothing has changed as far as that's concerned.

NEXT MAILING: June 14, 2000

GOLD: I continue to receive suggestions, information, and advice about gold. I appreciate all these efforts, but sadly, I must report that gold, so far, does only two things -- it either does nothing or it slides.

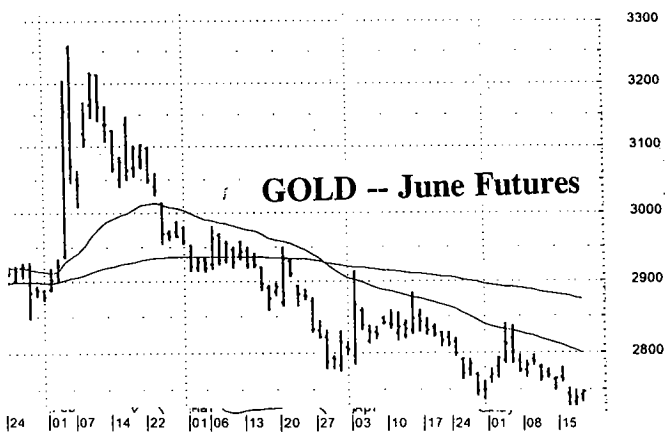
Mind you, I love gold -- I honestly believe that gold is the only true money. But it's obvious that except for the women of India (who wear their gold on their arms), the world doesn't want gold right now. No, what the world wants is dollars.

Dollars invested in T-notes (two-year T-notes) will give you a return of almost 7%. That's awfully attractive in the face of gold that's going nowhere. As long as the dollar is strong and pays near-7%, gold will rest. If the dollar collapses, ah, that's a different story. But the dollar hasn't collapsed, despite today's horrendous negative trade balance (although I don't know how much longer the dollar can continue to ignore the overseas pile-up of dollars).

You're skeptical regarding what I've written above? Then go argue with that master authority -- the market. The accompanying chart tells the story. The 144-day moving average of gold is trending down and as of this writing it is at 2878.40 on the June contract. Bearishly below the 144-day MA is the 34-day MA, which now stands at 274.40. And beneath even the 34-day MA is June gold itself, sitting at a lowly 273.80.

Now 273.80 may be the low for the year. And then again, it may not be. We obviously don't know. But one thing I do know -- if gold is going to go anywhere on the upside it will first have to better its average price of the last 34-days. So let's make it easy -- the first hint that gold is going to reverse to the upside would be June gold advancing above its 34-day MA -- advancing above 274.40.

Until that happens, all the fundamental studies in the world, all the over-sold studies, all the devout wishes of gold-philes will be of no avail. The price action, the price action, the price action -- that's where it is. And so far, the price action has said that nothing is happening yet to the world's only true money.



LATE NOTES: I have a feeling that the bear is moving ever-closer to the time when he's going to lose his temper. Look, this bear's been **denied** ever since the advance-decline ratio topped out on April 3, 1998. On August 4, 1999, the bear tipped his hand (for those who were willing to listen) by giving us a Dow Theory bear signal. Then on February 25, 2000, the bear signal was re-confirmed. And still the "experts" refused to believe that a primary bear market was in force. Even worse, **they denied it.**

The refusal to recognize his existence is really beginning to grate on the bear -- and he's getting angry. When the bear becomes angry enough, he'll go on a rampage. So far, bruin has done a lot of damage. But this is only the first phase of the bear market. My own "take" is that if or when the Dow breaks below **9796.03** (the March 7 low) the second phase of the bear market will be on. In the second phase of a bear market, stocks go down as they discount obviously deteriorating business conditions. The second phase of a bear market is no fun. I've lived through them. Believe me, they are NO fun.